

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

March 5, 2021

1:03 p.m.

MEMBERS PRESENT

Representative Josiah Patkotak, Chair
Representative Grier Hopkins, Vice Chair
Representative Calvin Schrage
Representative Sara Hannan
Representative George Rauscher
Representative Mike Cronk
Representative Ronald Gillham
Representative Tom McKay

MEMBERS ABSENT

Representative Zack Fields

COMMITTEE CALENDAR

HOUSE BILL NO. 81

"An Act authorizing the commissioner of natural resources to modify a net profit share lease."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 81

SHORT TITLE: OIL/GAS LEASE:DNR MODIFY NET PROFIT SHARE

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

02/18/21	(H)	READ THE FIRST TIME - REFERRALS
02/18/21	(H)	RES, FIN
03/05/21	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

JHONNY MEZA, Commercial Section Manager
Division of Oil and Gas
Department of Natural Resources
Anchorage, Alaska

POSITION STATEMENT: Gave a PowerPoint presentation on HB 81.

ACTION NARRATIVE

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CHAIR JOSIAH PATKOTAK called the House Resources Standing Committee meeting to order at 01:03 p.m. Representatives McKay, Rauscher, Hopkins, Hannan, Gillham, Schrage, and Patkotak, were present at the call to order. Representative Cronk arrived by teleconference as the meeting was in progress.

HB 81-OIL/GAS LEASE:DNR MODIFY NET PROFIT SHARE

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CHAIR PATKOTAK announced that the only order of business would be HOUSE BILL NO. 81, "An Act authorizing the commissioner of natural resources to modify a net profit share lease."

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JHONNY MEZA, Commercial Section Manager, Division of Oil and Gas, Department of Natural Resources, described HB 81 as legislation that would "modify certain aspects of the existing statutes for royalty modifications." He began a PowerPoint presentation on HB 81 [hard copy included in the committee packet] and turned attention to slide 2, titled "OUTLINE", which read as follows [original punctuation provided]:

- I. Overview of Net Profit Share Leases
- II. Why DNR would modify the royalty rate?
- III. Why DNR would modify the net profit share rate?
- IV. Overview of the modification process
- V. Appendix

MR. MEZA showed slide 3, titled "I. OVERVIEW OF NET PROFIT SHARE LEASES" and paraphrased slide 4, titled "ROYALTY AND NET PROFIT SHARE," which read as follows [original punctuation provided]:

- 1. What is royalty?
 - ♣ In its role as owner of the hydrocarbons in the subsurface, and in exchange for allowing a lessee the right to explore and develop said resource, the state reserves for itself a percentage of the gross value of that resource when produced by the company.

♣ This percentage (the royalty rate) is established in the oil and gas lease contract.

♣ All oil and gas leases offered by the state have a royalty provision.

2. What is a net profit share?

♣ For a small group of leases, the state, also acting as resource owner, reserves for itself, in addition to royalty, a percentage of the profits from the lease.

♣ A lease with royalty and net profit share is called a "Net Profit Share Lease."

♣ The "sharing of net profits" occurs once the exploration and development costs allocated to this lease are recovered through the revenues (net of operating costs) from this lease.

MR. MEZA further explained that the company pays the state a share of the profits, with percentages ranging from 30 to 79 percent. He said that while all oil and gas leases contain a royalty provision, only 26 leases contain a net profit share provision, referred to as net profit share leases (NPSLs).

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REPRESENTATIVE HANNAN referred to the 26 NPSLs and asked how many total leases exist.

MR. MEZA answered that the NPSLs represent a tiny minority of all oil and gas leases.

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MR. MEZA presented slide 5, which includes a table comparing royalty, production tax, net profit share, and profit to the lessee at various times throughout the life of the lease. He explained that the state, acting in its role as resource owner, establishes the royalty and net profit share rates in the contracts. Acting in its role as sovereign, the state also determines the production tax according to state law. While the commissioner of the Department of Natural Resources (DNR) is currently authorized under AS 38.05.180(j) to modify the royalty rate, there is no such statute pertaining to the net profit share rate; HB 81 is proposing that net profit share rate be included in the royalty modification statute. Mr. Meza noted that net profit share rate has been modified for one lease by legislative action and stressed that production tax would remain

unaffected . He went on to explain that royalty is assessed on the gross value of production from a lease, which is key in differentiating it from the net profit share rate, which is assessed on the profits net of any associated costs; however, royalty payments begin immediately at the start of commercial production, while net profit share payments begin when the lease reaches the "payout" stage, which is when two conditions are met: resources are produced, and some of the costs associated with exploration and development have been recovered. Mr. Meza concluded the explanation of this slide by explaining that a rate of net profit sharing is assessed for each NPSL; in contrast, the profit received by the lessee is likely assessed at the project level and may result from a collection of leases.

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REPRESENTATIVE HANNAN noted the reference to the DNR commissioner's statutory authority to modify royalties and asked how often modification occurs. She also referred to the one net profit share modification passed by the legislature and asked about the circumstances.

MR. MEZA responded that of the 1,598 current leases, 461 are producing, and there have been eight requests for royalty modification by the lessees. He also said that the specific legislative action to modify a net profit share would be discussed in a later slide.

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REPRESENTATIVE HOPKINS asked whether the royalty rates are public information.

MR. MEZA replied that they are.

REPRESENTATIVE HOPKINS followed up to ask whether it is also made public when NPSLs reach the payoff stage.

MR. MEZA answered that, because the state receives payments, the information is made public.

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MR MEZA presented slide 6, titled "NET PROFIT SHARE LEASES", which illustrates an example of an NPSL. By statute, he said, the DNR commissioner has the authority to issue oil and gas leases via a competitive bidding process; different types of

leases may be offered, those with a royalty component being most common. Leases that have both a royalty component and a provision for net profit sharing are the NPSLs; the example illustrated on this slide has a royalty provision of 20 percent and a net profit sharing rate of 93.2 percent. The winner of this lease was the bidder who offered the highest share of net profit.

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MR. MEZA presented slide 7, a graphical illustration comparing a lease with only a royalty component, and an NPSL with both royalty and net profit share components. Both leases have identical costs for capital expenditures, operating expenditures, transportation costs, and royalty; in contrast, the NPSL lease shows the net profit share to the State of Alaska in its role as resource owner and lower production tax to the State in its role as sovereign. As a result, the NPSL lease shows less profit retained by the lessee.

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REPRESENTATIVE RAUSCHER referred to an earlier remark by Mr. Meza and asked if it was correct that eight companies have requested this legislation.

MR MEZA clarified that DNR has received eight applications for royalty modifications since the statute was enacted in 1995.

REPRESENTATIVE RAUSCHER asked why a company would want to do that.

MR. MEZA replied that this question would be answered later in the presentation.

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REPRESENTATIVE MCKAY stated that he believes the idea is to "help marginal leases" get back into production by writing off development costs against the royalty.

MR. MEZA said that Representative McKay is correct, and that the objective of DNR is to "prevent resources from remaining stranded."

CHAIR PATKOTAK referred to Representative Rauscher's earlier assertion that eight companies requested this legislation and

clarified that the companies requested changes to their lease terms; they don't necessarily support this legislation.

MR. MEZA further clarified that the eight applications were for royalty modifications.

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MR. MEZA presented slide 8, titled "MAP OF NET PROFIT SHARE LEASES", which showed a map of the North Slope with the existing oil and gas units and distinguishing the 26 NPSLs. He explained that an oil and gas unit contains a set of leases, either NPSLs or leases with only a royalty component. He said that it is worth noting that there also exist leases, issued in the 1970s and 1980s, which are not a part of any unit and have net profit shares rates ranging from 30 to 79 percent.

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REPRESENTATIVE HANNAN asked for further explanation of the map and referred specifically to the numbered leases on the Duck Island Unit. She asked whether the two NPSLs in the unit comprised the entirety of the leases and or if a portion of the tract was not an NPSL.

MR. MEZA answered that the map was showing only the NPSLs with the remaining area, shown in yellow, containing royalty-only leases.

REPRESENTATIVE HANNAN followed up to ask whether it's the same company that owns both the royalty-only leases and the NPSLs.

MR. MEZA replied that while different ownership of the leases is possible, it's most commonly the same owner.

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MR. MEZA finished his explanation of the map with the note that some of the NPSLs have already paid a total of \$1.17 billion; others have not yet shared profits because they are not yet producing or have not yet reached the payout stage.

MR. MEZA continued to slide 9, "26 ACTIVE NET PROFIT SHARE LEASES ON THE NORTH SLOPE," which showed for each lease the net profit share rate, royalty rate, whether the lease has reached the payout stage, and the cumulative net profit sharing to the state. He noted that most of the NPSLs were issued in the 1970s

and 1980s, while three were established more recently due to "lease segregation," which means the original lease was partitioned into two leases. He said HB 81 proposes authorizing the DNR commissioner to modify both the royalty rate and the net profit share rate if DNR finds that doing so is in the best interest of the state. The modification of the net profit share rate would comprise a temporary reduction of the rate with a gradual increase under certain conditions, to be illustrated later in the presentation.

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REPRESENTATIVE HOPKINS asked whether there is a definition for "in the best interest of the state."

MR. MEZA answered that the state is mandated by statute to maximize the value of the resources; by considering royalty or net profit share modifications, the goal is to encourage additional production of leases which would otherwise remain stranded.

REPRESENTATIVE HOPKINS asked whether the goal is more production versus a higher monetary value per barrel.

MR. MEZA responded that without modification to the rates there would be no production, and more production means more revenue.

REPRESENTATIVE HOPKINS referred to slide 9 and noted that 14 of the 26 leases have not yet reach payout stage. He asked whether all 26 leases would be eligible for modification or only those that have reached the payout stage.

MR. MEZA answered that HB 81 doesn't specify a particular case for modification but noted that Representative Hopkins' question makes sense. He said that the bill is intended to be comprehensive, and that it would immediately impact those leases currently in the payout stage and would have future impacts on leases not yet in that stage.

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REPRESENTATIVE HANNAN referred specifically to the Point Thomson Unit as having the oldest lease and asked Mr. Meza to explain why that lease hasn't paid the net profit share.

MR. MEZA answered that the Point Thomson unit began production in 2016 and is in a group of leases that do not include any

NPSLs. He said that when a company considers applying for royalty or net profit share modification, a convincing and clear plan must be provided to DNR showing that a modification would improve the lease's economic viability for future production. He said DNR analyzes and reviews all applications.

REPRESENTATIVE HANNAN asked, "Did you say that there are some leases in Point Thomson that are in production, but they are royalty agreements?"

MR. MEZA replied that the leases which are producing only contain the royalty component.

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REPRESENTATIVE MCKAY explained that Exxon was building out the infrastructure in the Point Thomson area, which is why there was no production for so many years after the first issuance of the lease.

MR. MEZA told the committee that Representative McKay was correct.

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REPRESENTATIVE SCHRAGE asked whether it's correct to say that the proposed bill would allow the adjustment of NPSLs for fields that are in production as well as those that have not reached the payout stage.

MR. MEZA answered that is correct, and explained that HB 81 would allow the lessee to apply for modification of royalty and/or net profit share regardless of whether the lease is producing or not, because the statute "contemplates clearly defined scenarios under which an applicant needs to support its application." He said that the bill is constrained to apply only to specific scenarios under which modification might be considered.

REPRESENTATIVE SCHRAGE asked whether it would be a correct assumption that "we would be targeting those fields that have not reached that payout stage such that by modifying that profit sharing agreement, economically, they would be motivated or incentivized to have output and begin production."

MR. MEZA replied that Representative Schrage's statement is a possibility and that it could encourage incremental production,

with associated incremental revenues, from both producing and non-producing leases.

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CHAIR PATKOTAK surmised that HB 81 would be establishing parameters within which the state may operate when considering modifications to lease terms.

MR. MEZA replied, "That is correct."

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MR. MEZA presented slide 10, "MODIFICATION OF NORTHSTAR UNIT NPSLS THROUGH LEGISLATIVE ACTION IN 1996," showing four leases in the Northstar Unit originally offered in 1980 with a fixed royalty rate of 20 percent; companies bid on the leases, which were awarded to those who offered to pay the highest net profit share rate. The lessee, British Petroleum (BP), evaluated future development of the lease and informed DNR of the expected viability of the project, given the costs. In 1996 DNR and BP negotiated net profit share and royalty rate modification terms and proposed changes to the legislature, which passed a bill to modify both rates. The legislature found that unless the net profit share rates were modified the unit would be unlikely to produce until 2002, if at all. The purpose of modifying the rates, Mr. Meza explained, was to encourage production in a case where none would otherwise occur, which would result in no revenue to the state.

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CHAIR PATKOTAK asked whether it is currently incumbent on the legislature to change both royalty and net profit share rates.

MR. MEZA explained that the DNR commissioner is currently authorized by statute to modify royalty rates, if DNR finds that the modification is in the best interest of the state. In contrast, net profit share rate modifications must be done by legislative action. He said HB 81 proposes giving the DNR commissioner the authority to modify the net profit share rate under the statute that allows modification of the royalty rate. In response to Chair Patkotak, he relayed that in 1995 the legislature enacted the statute that allowed the DNR commissioner to modify royalty rates because the net profit share rates were not eligible for modification under statute. The net profit

share rates on the BP leases were modified through legislative action in 1996.

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REPRESENTATIVE MCKAY stated his belief that ConocoPhillips Alaska, Inc. originally owned the Northstar Unit leases and sold them to BP, which then approached the state for net profit share modification. He said that if the field or pool is "shut in," then production may never occur or may otherwise become uneconomic.

MR MEZA replied, "That is precisely correct."

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REPRESENTATIVE HANNAN asked whether the Northstar leases have produced as expected since the modification was made. She also asked whether these are the leases that recently transferred from BP to Hilcorp Alaska, LLC.

MR. MEZA replied that production began in 2002 and has been approximately 178 million barrels of oil.

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MR. MEZA introduced the next section of the presentation with slide 11, "WHY DNR WOULD MODIFY THE ROYALTY RATE" and proceeded immediately to slide 12, "STRANDED RESOURCES MEANS ZERO PRODUCTION AND ZERO REVENUES TO THE STATE," which illustrates a 2005 case in which DNR granted a modification. He explained that the Oooguruk unit has four NPSLs and several royalty-only leases; in its application, the developer, Pioneer, said that without lower royalty rates the project would "fail to meet minimal economic targets," thereby leaving the project stranded and providing no revenue to the state. He said DNR did its own analysis and agreed with that assessment and allowed a temporary reduction in royalty rates to 5 percent. Production began in 2008 and cumulative revenues to the state have been \$145 million in royalties and \$12 million in net profit sharing.

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MR. MEZA continued to slide 13, "WHY WOULD DNR ALLOW THE MODIFICATION OF THE ROYALTY RATE?", which demonstrates revenues and expenditures over time for two hypothetical leases with and without royalty modifications. The two cases have identical

development costs, operating costs, and revenues; the production tax, royalty rates, and net profit sharing are considered in the economic evaluation for the project. From the perspective of the lessee, Mr. Meza explained, the project without royalty modification is not profitable, so "the investment is not sanctioned, resources are stranded, and the projected revenues to the state are not realized and they become zero." Maximizing the value of resources is in the best interest of the state, so reducing the royalty rate in turn leads to a profitable enough project. In this way, resources are produced, and the state realizes revenue. Since the leases in this hypothetical also have net profit sharing components, Mr. Meza said, "it is possible that the same goal could have been achieved by modifying the net profit share rather than the royalty rate," which would be possible under HB 81.

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REPRESENTATIVE HOPKINS asked at what point during the life of the lease there would be a change in the net profit share rate, should HB 81 pass.

MR. MEZA answered that the only change in this example is the royalty rate. He said that in describing this hypothetical the question was posed, "Could DNR have obtained a similar result of incentivizing the investment by, instead of modifying the royalty, we modified the net profit sharing?".

REPRESENTATIVE HOPKINS asked whether there would be a demonstration showing a point in the project when a developer would understand that the field is unprofitable, leading it to apply for a net profit sharing modification.

MR. MEZA replied that slides 24 and 25 would show that possibility.

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MR. MEZA continued to slide 14, titled "HISTORY OF DNR ROYALTY MODIFICATION APPLICATIONS." This slide is a chart showing the outcome of each application for royalty modifications since 1995. Of eight applications, three were approved; two were denied; and three were withdrawn by the applicant. The new terms of the three approved leases contained a provision establishing the specific modification of the rate. In the case of the Oooguruk (Kuparuk and Nuiqsut) field, the royalty rate was reduced to 5 percent at the beginning of production and

gradually increased back to its original level when the lease reached the payout stage. For the Oooguruk (Nuna Torok) field, the modification of royalty was granted but the company didn't make the necessary capital investment; therefore, the modification was rescinded.

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CHAIR PATKOTAK stated his understanding that when rate modifications are made there's a clause that specifies capital investments are required.

MR. MEZA answered that the decision issued by the DNR includes "multiple covenants and conditions" in order to keep the modification.

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REPRESENTATIVE HOPKINS asked whether the sliding scale mechanisms are unique to each field or developer, and he asked whether HB 81 would allow the DNR commissioner to continue having that latitude.

MR. MEZA answered that HB 81 would maintain the commissioner's existing flexibility in deciding the mechanism for modification and would not only maintain it, but would expand it to modifying the net profit share rates in NPSLs if, through DNR's best interest finding, including public comment and presentation, it's found that modification is in the best interest of the state.

REPRESENTATIVE HOPKINS noted that it wouldn't be necessary for the rate to go back up.

MR. MEZA replied that it's possible to have a case in which the net profit share rate doesn't need to return to original levels, depending on the project in question. He said that with reference to the NPSLs, there are also other mechanisms available.

REPRESENTATIVE HOPKINS said that getting the fields productive is a good goal.

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CHAIR PATKOTAK asked for a brief overview of what the parameters are in determining eligibility for an NPSL modification.

MR. MEZA replied that a partial answer to his question is in the presentation and that he would provide further explanation.

CHAIR PATKOTAK noted that it would be helpful in phrasing the bill and to show that there are checks and balances.

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MR. MEZA explained that when DNR proposes a modification, it's mandated that the department publish a best interest finding, which is subject to a public comment period, and to "offer a presentation" to the legislative budget and audit committee, which will be described later in the meeting.

MR. MESA introduced the third section of his PowerPoint presentation, "III. WHY DNR WOULD MODIFY THE NET PROFIT SHARE RATE?" and paraphrased slide 16, titled "1. INCREASE PRODUCTION FROM OTHERWISE STRANDED RESOURCES," which read as follows [original punctuation provided]:

A. Under certain circumstances, even with royalty modification, it is possible for continuing or for incremental production from pools which contain NPSLs to be stranded.

- If resources are stranded → Project does not happen → No royalty or net profit sharing to the State
- Modification of the net profit share may make such production economic.

B. Modification of royalty and/or net profit share for pools which would otherwise be stranded could extend the life of such field and other existing fields.

- This would result in additional royalties, net profit share, taxes, etc. that the State would not otherwise receive.

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MR. MESA paraphrased slide 17, "2. FLEXIBILITY FOR ROYALTY MODIFICATIONS," which read as follows [original punctuation provided]:

Currently, DNR can modify royalty but not the net profit share.

A. NPSL Modifications would give DNR flexibility to elect targeted reductions and could be a useful tool in environments of high oil price volatility.

- Under certain circumstances, it may be in the best interest of the State to modify net profit share instead of royalty.

- Royalties are paid sooner than net profit shares and are more predictable over the life of an investment.

- Alternatively, smaller reductions in both royalty rate and net profit share may allow for a more advantageous "blended" incentive structure.

B. NPSL Modifications would enable DNR to increase net profit shares in scenarios where DNR can structure potential payback of foregone revenues in the event of higher prices or production levels.

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REPRESENTATIVE SCHRAGE asked whether he's correct in his understanding that in an economic environment with low oil prices a royalty reduction would allow a production to begin, but the state would lose money should oil prices increase; allowing adjustment to the net profit share rate would mean that in this case, the state receives increased revenue later.

MR. MEZA responded that Representative Schrage's summary is one possible scenario showing the "valuable flexibility" that HB 81 would allow the DNR commissioner.

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MR. MEZA presented slide 18, "WHY WOULD DNR ALLOW THE MODIFICATION OF THE NET PROFIT SHARE RATE? A HYPOTHETICAL EXAMPLE," which shows two graphs representing a case in which production is defined by a set of leases with both royalty and net profit sharing, and another case in which it's defined only by net profit sharing, with profitability shown from the perspective of the lessee. An evaluation of the investment is determined in "year zero" (a point at which no expenditures or revenues have existed), including a combination of variables including production, price, and cost, to determine whether investment should occur; if projections show a negative return, investment will not take place. Mr. Meza directed the committee's attention to the graph, titled "20% of production allocated to the NPSLs" where a light blue line represents

profits with no modification to the rates, showing negative value for the project. By modifying only the royalty rate, shown by a dotted orange line, the value becomes positive. By modifying only the net profit share rate, as shown by the dashed blue line, the project likewise becomes more valuable than with no modifications. Mr. Meza then directed the committee's attention to the other graph titled "100% of production allocated to the NPSLs," which shows modification of either rate by itself is not enough to make the project economically feasible, thereby changing the company's investment decision; only combined modification of royalty and net profit share rates make the project economic. When granting a modification, Mr. Meza explained, the objective is not to guarantee a profit to the company, but to incentivize the company to sanction capital investment to develop and produce the resources. Included on the slide was the following note [original punctuation provided]:

The State may find that, to make a project economic, it is in its best interest to...

A. Modify only the net profit share rate rather than the royalty rate without giving up too much of its potential revenues

B. Modify both if the modification of either is not enough to affect the investment decision of the lessee

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MR. MEZA paraphrased slide 19, " 3. STREAMLINE PROCESS FOR NPSL MODIFICATIONS," which read as follows [original punctuation provided]:

A. Current process to modify NPSLs is for DNR to negotiate a modification package and submit proposal for legislative action. • In 1996, four NPSLs in the Northstar Unit were modified to a sliding-scale royalty.

- The Legislature ratified the modification in HB 548 (Chapter 139 SLA 96).

- The Alaska Supreme Court upheld the modification in *Baxley v. State*, 958 P.2d 422 (Alaska 1998).

B. Providing for NPSL Modification in statute would streamline NPSL modification process, while allowing

for the Legislature to set conditions and limits on NPSL Modifications.

C. As with Royalty Modification, NPSL Modification decisions are reported to the Legislature, which may require hearings or take additional legislative action.

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REPRESENTATIVE HANNAN asked whether other administrations have proposed similar legislation since 1996 when the four NPSLs in the Northstar Unit were modified.

MR. MEZA said that he does not know of any previous legislation.

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REPRESENTATIVE SCHRAGE said that modification of the rates seems to have merit and noted that "we've proven that these agreements can be changed through the legislative process" and asked about the advantage to giving DNR the flexibility in making the decisions, rather than continuing using the legislative process.

MR. MEZA replied that the current statute for modification establishes the process that DNR must follow for complicated and detailed financial and technical information; while legislative review is a possibility, HB 81 proposes giving the DNR commissioner the authority to carry out that process, publish the findings for public comment, and present to the legislature. He also noted that in many cases the applications contain sensitive and confidential information meant solely for review by DNR.

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REPRESENTATIVE HOPKINS referred to the "royalty modification checkbox" currently required under statute and asked whether the checkboxes would be in statute under HB 81 or in regulations by DNR.

MR. MEZA replied that HB 81 does not propose changing any existing processes, in fact, it proposes using the same process for reviewing net profit sharing modifications as it does for royalty modifications.

REPRESENTATIVE HOPKINS surmised that net profit sharing modifications would be in statute, not in regulations.

MR. MEZA said, "That is correct."

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MR. MEZA presented the fourth and final section of the presentation with slide 20, "IV. OVERVIEW OF THE MODIFICATION PROCESS," and proceeded immediately to paraphrase slide 21, "WHAT HB 81 ACCOMPLISHES," which read as follows [original punctuation provided]:

1. Expand the royalty modification process to include NPSLs:

A. Commissioner would have the authority to modify net profit share rates in the same manner as royalty rates under AS 38.05.180(j).

- Objective is to encourage production of otherwise stranded resources.

2. Other changes:

A. Creates an additional qualifying scenario for modification of either royalty or NPSLs

- For producing pools, where incremental production requires incremental capital expenditures, which, in the absence of modification, would be uneconomic.

B. Clarifies that test production during exploration does not disqualify a field or pool from royalty or NPSL modification based on new production.

- This codifies DNR's existing interpretation and is offered to resolve a potential ambiguity. It does not constitute a change in current policy.

MR. MEZA paraphrased slide 22, "WHAT TYPE OF MODIFICATION IS WARRANTED?", which read as follows [original punctuation provided]:

A. Royalty Modification is capped at certain minimum royalty rates.

- Five percent for .180(j)(1)(A) or three percent for .180(j)(1)(B)-(C).

B. The proposed NPSL modification also establishes a minimum net profit share of ten percent.

C. The modification may be based on a sliding scale mechanism.

- It could vary with the price of oil, volume of production, per-barrel costs, etc.

D. Modifications of royalty or net profit share can be either lower or higher than the original percentages. (AS 38.180(j)(3))

- In certain circumstances, this would allow DNR to recapture foregone royalties or net profit revenue if oil prices rise, or even to participate in "upside" price movements if DNR provides "downside" relief.

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CHAIR PATKOTAK asked whether there's a way for the state, rather than the developer, to request a modification.

MR. MEZA answered that the current statute for royalty modification, and now proposed for net profit sharing modification, specifies application by the lessee due to requiring the inclusion of technical and financial information.

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REPRESENTATIVE RAUSCHER surmised that, without an application, DNR cannot initiate the modification process.

MR. MEZA replied, "That is correct."

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MR. MEZA presented slide 23, "ELIGIBLE SCENARIOS FOR MODIFICATION." The first three scenarios currently exist under the current statute for royalty modification; HB 81 would allow net profit share modifications in these scenarios as well. Mr. Meza explained the scenarios on the slide, described as follows [original punctuation provided]:

A. New Production: If the development of a new field or pool would not be economic without modification, so long as the field or pool is sufficiently delineated. AS 38.05.180(j)(1)(A)

B. Extend Production: To prolong the economic life of a field or pool when rising per-barrel costs (due to

declining production or otherwise) would make continuing production no longer economic without modification. AS 38.05.180(j)(1)(B)

C. Restore Production: To reestablish production of shut-in oil or gas that would otherwise not be economically feasible without modification. AS 38.05.180(j)(1)(C)

MR. MEZA explained that HB 81 proposes adding a fourth scenario of eligibility for modification, which would apply to both royalty and net profit share modifications; illustrated on the slide as "scenario D," which read as follows [original punctuation provided]:

D. Incremental Production: If incremental production from producing pools requiring incremental capital expenditures is uneconomic in the absence of modification.

Examples: Expansion of existing pools, additional drilling pads, enhanced oil recovery projects, etc.

MR. MEZA gave additional examples, including expanding a currently-producing pool by drilling new wells outside the boundaries of the known reservoir and a project targeting incremental production by building additional drilling pads and using an extended-reach drilling rig. He explained that DNR is attempting to unlock additional resources which, without modification of the rates, may be stranded; extending the lives of existing pools means reaching existing resources, and receiving the associated revenues, without creating a larger infrastructure footprint.

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REPRESENTATIVE GILLHAM asked whether the DNR commissioner would have the sole authority to approve an application for modification.

MR. MEZA replied that the existing statutes for royalty modification allows the commissioner sole authority and include a significant period of review of technical and financial information. He noted that HB 81 would not change that process.

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REPRESENTATIVE HOPKINS asked about the original impetus for HB 81, given that it's been 25 years since the legislative decision for net profit share modification.

MR. MEZA summed up his previous explanation.

REPRESENTATIVE HOPKINS said that he understands that production has been declining since approximately 1988, but he wants to know from where the idea for the bill came.

MR. MEZA said that he would look into it.

[2:31:04 PM](#)

REPRESENTATIVE HANNAN asked whether there is a companion bill in the Senate.

MR. MEZA replied that he is not aware of a companion bill addressing net profit share rates, although he proffered SB 61 is a similar bill with the same goal.

REPRESENTATIVE HANNAN asked whether SB 61 had been presented to the Senate Resources Standing Committee.

MR. MEZA answered that it had.

[2:32:02 PM](#)

CHAIR PATKOTAK offered his assumption that at this time there are no pending applications for modification.

MR. MEZA told the committee that Chair Patkotak is correct.

[2:32:20 PM](#)

MR. MEZA resumed his presentation with slide 24, "ELIGIBLE SCENARIOS FOR MODIFICATION," which shows two graphs representing scenarios A and B from slide 23. The graph labeled "New Production" illustrates scenario A, and the graph labeled "Extend Production" illustrates scenario B; for this example, scenario B has been producing for 16 years and projections show that future production would translate into an operating loss, with the economic life of the field nearing its end. Modification via a reduction of royalty or net profit share rates could ensure that production continues, thereby continuing the associated revenues to the state.

MR. MEZA used this graph to answer Representative Hopkins' earlier question by explaining that there were several years with net profit share payments; however, the field would require modification to the lease terms in order to ensure future production.

[2:35:00 PM](#)

REPRESENTATIVE HOPKINS referred to slide 10, where Mr. Meza asserted that the developer who bid the highest net profit sharing rate would be awarded the lease and described a hypothetical situation. He asked whether it's possible for a bidder, committed to a net profit sharing rate of 99.999 percent, can decide during development that the rate is untenable and modify it to a rate lower than what the other bidders proposed.

MR. MEZA explained that there are several stages in development including exploration of wells; appraisals, which provide information on volume of the resource; and determination of how the facilities would need to be designed to produce the resource. This means actual production of the resource could begin 10 to 20 years after the lease is awarded. The rate in the initial bid may be economically unfeasible by the time the field is fully developed.

REPRESENTATIVE HOPKINS surmised that it would take a decade or more for a developer to realize that its bid is not profitable.

MR. MEZA replied, "That is correct."

[2:38:26 PM](#)

REPRESENTATIVE MCKAY offered his experience of being involved in a project in which the developer intended to frack, but due to the geology of the area the plan was impossible to execute so changes were made.

[2:39:16 PM](#)

CHAIR PATKOTAK asked Mr. Meza whether there are periodic goals within the life of the lease that need to be met in order to make the lease eligible for modification.

MR. MEZA explained that with the issuance of a lease, the lessee has a period during which there are no requirements for

exploration or development; in a few cases DNR will propose commitments, but most frequently activities occur in a manner deemed appropriate by the lessee. At a certain point, however, the lessee must demonstrate exploitable resources.

[2:41:39 PM](#)

MR. MEZA continued to slide 25, "ELIGIBLE SCENARIOS FOR MODIFICATION," which is a continuation from slide 24 and shows two graphs representing scenarios C and D from slide 23. The graph depicting scenario C shows the lease in year 21, and production has stopped; without modification there is no incentive for the lessee to continue producing, so there will be no more resource extraction and no more revenues to the state. The graph depicting scenario D, which is proposed under HB 81, shows the lease is in year 15 and the lessee is considering capital investment in the field, such as drilling outside the boundaries of the known reservoir. The investment is not expected to be profitable; however, and the rate modifications would be necessary to incentivize the developer to make the necessary investment, thereby providing revenue to the state.

[2:43:19 PM](#)

MR. MEZA presented slide 26, "DECISION-MAKING PROCESS," which read as follows [original punctuation provided]:

A. HB81 does not propose to change the modification process.

B. A producer applying for a royalty modification must provide a clear and convincing showing that they meet the statutory requirements.

- A higher standard of proof than required for most other DNR applications.
- Applicants required to provide abundant evidence to justify any request for relief.

C. DNR may require (for .180(j)(1)(A)) or request (for .180(j)(1)(B)-(C)) that producers pay up to \$150,000 per application for consulting work to support DNR's evaluation of the application.

D. Publication of Best Interest Finding and offer presentation to Legislature (AS 38.05.180(j)(9)-(10))

E. If granted, modifications are not transferrable without the authorization of the Commissioner. (AS 38.05.180(j)(5))

[2:45:19 PM](#)

REPRESENTATIVE MCKAY asked for an estimate for how much production would increase as a result of HB 81.

MR. MEZA responded by explaining that economic viability of the fields is the focus, with estimates of future production to be included with the application for modification.

[2:46:50 PM](#)

REPRESENTATIVE GILLHAM asked whether there must be a minimum production level before modifications can be put into place. He referred to the Kuparuk River Unit on slide 9 and asked whether that lease would have to produce 50,000 barrels a day in order to get a modification, or whether the modification would be in affect with the first barrel of oil.

MR. MEZA replied that HB 81 doesn't propose requiring a certain level of production but that the information would be important when evaluating the application for modification. In the Oooguruk unit modification, which had been approved by the legislature, the reduced royalty rate was in effect with the first barrel because the pool hadn't been producing previously and had a "defined expiration mechanism" that would gradually return royalty rates to the original level.

[2:48:54 PM](#)

CHAIR PATKOTAK referenced slide 26 and noted that HB 81 isn't proposing changing the process for royalty rate adjustments, and he asked Mr. Meza to clarify whether HB 81 requires the DNR commissioner to follow the same process for net profit share rate modifications as it does for royalty modifications.

MR. MESA confirmed that is correct. He said HB 81 would establish that DNR follow the same process as is applied for royalty modifications.

CHAIR PATKOTAK noted that the focus thus far has been on the North Slope and asked whether HB 81 would affect oil production in the rest of the state.

MR. MESA responded that there are no NPSLs anywhere other than the North Slope.

CHAIR PATKOTAK asked whether HB 81 would apply to all oil and gas production instead of being specific to a region.

MR. MESA replied, "Yes, correct."

[2:50:39 PM](#)

REPRESENTATIVE SCHRAGE stated his assumption that there are other factors that go into a company's production decision besides the royalty and net profit share rates.

MR. MESA replied that there are other variables such as price, the cost structure of the project, and the fiscal system in general. He said that this presentation is showing only the cases of royalty and net profit share modifications because those are areas "within the purview of the DNR commissioner."

REPRESENTATIVE SCHRAGE asked whether there is a scenario in which rate modification could coincide with changing economic conditions and result in the state receiving less revenue than it would have under the original lease agreement.

MR. MESA answered that DNR considers both current and expected future price levels over the life of the project, and weighs both highly optimistic and highly pessimistic cases, and everything in between, in modification adjustments.

[2:53:04 PM](#)

CHAIR PATKOTAK said that in future meetings the committee would be looking at the process by which an NPSL is modified and what criteria the lessee must meet.

[2:53:55 PM](#)

REPRESENTATIVE HOPKINS said that he would be looking for an answer to the question of the origination of HB 81.

[2:54:01 PM](#)

REPRESENTATIVE HANNAN noted that she would like to know "how long the idea has been brewing" and why it hasn't been addressed before now, especially in the face of declining production.
[HB 81 was held over.]

2:55:59 PM

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:56 p.m.